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THE ALDRICH PLAN FOR MONETARY LEGISLATION

The plan for monetary legislation suggested by Senator Aldrich contains many indications of the skilful handiwork of its experienced author. It bristles with provisions obviously designed to insure not only its passage but also its general acceptance by the people as an equitable means of banking reform. In particular, extraordinary precautions seem to have been taken both in determining the form of organization and in the limitations placed upon the lending power of the proposed bank in order to forestall objections of a political or sectional nature. Banking principles and needs have not, on this account, been overlooked, and it may be predicted with confidence that if the measure were to be adopted in its present form, a material improvement in our banking system and methods might be expected to follow. At this stage in the movement for reform, however, and notwithstanding the risk of leaving with the reader a less favorable impression than the measure deserves, it seems advisable to concentrate attention on amendments which will either facilitate its passage or render it more serviceable.

To the weight attached to political and sectional considerations may be attributed the highly complicated form of organization of the proposed bank. In the opinion of the writer practically every specific objection or fear which has been expressed on the organization side of the subject during recent discussions of the central bank problem has been successfully met—a remarkable feat of constructive imagination. The resulting inevitable complexity may, however, prove in itself a serious obstacle on account of the difficulty of making the arrangement generally intelligible. If the same results could be secured by more simple means it would be a great gain. I have, however, no simpler alternative to take its place. Indeed the one modification which I would urge would add slightly to its present complexity. In addition to the six *ex officio* government directors and the fifteen directors, one chosen by the board of directors of each branch, the plan provides for twelve directors to be chosen by the banks on the basis of their capital and surplus and for a similar number to be chosen by the board thus constituted. In order to prevent an unduly large representation from the Northern states, east of the Mississippi, which have the bulk of the banking capital of the country, and to avoid the consequent

danger of sectional antagonism, it might be of advantage to limit the number of directors in the last two groups taken together to three from any one district and to five from adjoining districts. With this additional limitation the fear rather than the likelihood—which in any event would seem to be very remote—that the management of the Bank might be so composed as to fail to give all sections of the country proper consideration should be entirely removed.

There seems indeed to be a general tendency to attach undue importance to the question of the organization of the proposed bank. Limited almost entirely to advances upon commercial paper and working always very much in the public eye there is little likelihood that under any form of organization its resources would be used for selfish purposes whether individual or sectional. The wise use of the resources of the bank in normal times and the conservative husbanding of a considerable portion of them for emergencies are far more vital matters, and they can not be entirely safeguarded by provisions relating to organization or by restrictions upon lending power. Forebodings of this nature may well be occasioned by a provision in the bill which makes it incumbent upon the Bank to lend at a uniform rate throughout the country. Provision will doubtless be made for different rates on the different kinds of loans which the Bank is authorized to grant, though no such provision appears in the bill in its present rough draft. Even though the control of the Bank might be largely in eastern hands it is certain that the bulk of its loans will be made in the West and South where lending rates are uniformly somewhat, and in many places considerably, above those in the East. On purely banking grounds much might be said against this restriction but it goes without saying that without it there would be slight chance of the passage of the measure. It will, most certainly, increase the difficulties which will have to be met by the management of the Bank. Demands for an excessive amount of accommodation from particular sections of the country can not be checked automatically by advances in rates without making it entirely unprofitable for banks in other sections to resort to the Bank for any accommodation whatever. There is a grave possibility that its entire lending activities in normal times may be confined to those sections of the country where interest rates are high and where the average quality of loans, taken as a whole, is relatively unsatisfactory as regards liquidness. No

other country presents an exactly parallel case because elsewhere through the branches of the other banks much of the work of equalizing lending rates is performed. Here that task would devolve almost entirely upon the central bank. And its accomplishment would require not only far greater power than is possessed by any existing central bank but also, it may be added, vastly more than the proposed bank could by any possibility secure.

In these circumstances it is of the utmost importance that the management of the Bank be protected from borrowers, not so much to prevent unwise action on its part as to protect the Bank from criticism and distrust which would be certain if the management were obliged to refuse many loans out of a large number to one section of the country while making perhaps all of the limited number of loans desired in some other section. Having restricted the management to a uniform rate, thus taking away one means of defense, it is necessary to provide others to take its place. In a measure this is accomplished in the bill proposed by Senator Aldrich through certain limits placed upon the lending power of the Bank, though not to the extent which would seem to be required. Banks are to be allowed to rediscount directly with the Reserve Association only short-time commercial paper, i. e., paper maturing within twenty-eight days which shall have already been made at least thirty days before the date of rediscount. The amount of such paper taken, moreover, is not to exceed the capital of the bank applying for accommodation. Doubtless the management of the Reserve Association will raise objections if a bank were regularly to apply for rediscounts up to this limit. So far as this class of loans is concerned the restrictions would seem to be entirely adequate, and if paper of this kind should prove to be the only paper ordinarily brought to the Bank for rediscount no trouble need be feared. But elaborate provisions are found in the bill for other kinds of loans, and many bankers as well as the public are certainly likely to assume that their use is not to be confined to exceptional occasions. The passage of the measure should not be facilitated by the creation of hopes and expectations which can not be realized.

Banks are to be grouped in local associations and these associations may guarantee commercial paper having not more than four months to run. This paper may then be presented to the Reserve Association for rediscount. The amount of commercial paper which may be guaranteed by a local association for an

individual bank is not limited, although the total guarantees of the Association may not exceed the aggregate capital and surplus of its member banks.

There is a wide difference of opinion among bankers as to the extent to which banks would resort to this means of providing themselves with bankable paper. It is thought by some that most bankers would refrain from making application for guarantees from their local associations because it might be regarded as a confession of weakness. But this is a view which is most likely to prevail in the Eastern states where bank resources are ordinarily more than ample for local requirements. In those parts of the country in which there is a relative scarcity of capital of all kinds, as in Oklahoma where the normal lending rate is 8 per cent and upwards, it would seem probable that virtually all of the banks would resort to this device, thus removing any stigma from the practice.

By exacting a rate upon this guaranteed paper very much higher than that upon short-time paper the management of the Bank might succeed in checking applications for its rediscount. But it does not seem wise to place this heavy burden upon the management of the Bank. If it is believed that ordinarily the banks should not expect much accommodation on long-time paper from the Reserve Association, then it will obviously not prove disadvantageous to place further restrictions upon the amount which the local associations may guarantee. Moreover, if the Reserve Association in normal times should rediscount short-time paper for a particular bank to about the amount of its capital and in addition an equal amount of long-time paper, it would certainly seem to be a dangerous reliance upon the lending resources of the central institution. Instead, therefore, of guarantees by the local association to the extent of the entire capital and surplus of the members, I venture to suggest the advisability of limiting such guarantees to one half of the capital, or perhaps to one half the capital and surplus of the individual banks.

It might be felt, however, that this definite restriction upon the amount of paper which any single bank might rediscount would prove an obstacle in the way of needed relief in emergencies. But the plan of Senator Aldrich contains a valuable provision designed to meet such contingencies. By special vote of the executive committee and with the approval of the Secretary of the Treasury the Reserve Association may discount the notes of banks

guaranteed by the local association and secured by the deposit with it of securities taken at two thirds of their market value. Under the terms of this clause it will be possible to assist threatened banking institutions, following the precedents established by European central banks and our own clearing-houses. Finally, it may be noted that the bill permits banks to accept commercial paper drawn upon them to the amount of half their capital and surplus, and contains a further provision under which the central institution may rediscount such paper for its original purchasers. Taking account of all the various lending activities proposed for the Reserve Association it would seem clear that some further restriction upon the rediscounting of long-time paper would not hamper its lending operations or weaken its power to serve the business community.

If the Reserve Association is to serve a useful purpose it should be clearly understood by the public generally as well as by bankers that it is not to be one of its functions to contribute largely to the aggregate amount of credit regularly at the disposal of borrowers. There can be little question that the volume of bank credit in this country is already large enough considered with reference to total capital or with reference to the amount of working capital of corporations and business firms. It is desirable, however, to make commercial paper the most liquid and therefore the most attractive asset which the banks can hold. It will further the economic development of the country if the relative standing of the collateral loan and commercial paper can be reversed. It is also desirable to foster banking methods and arrangements which will tend to check not so much the concentration of surplus banking funds in New York as to facilitate their general employment throughout the country, and not as at present in collateral loans in that city. These objects can be attained without large loans by the Reserve Association through its ability at all times to make advances upon commercial paper to meet the regular seasonal requirements of the other banks and their more occasional needs during periods of financial stress.

A large volume of loans at all times by the Reserve Association is not merely unnecessary for the accomplishment of the primary functions of such an institution, but would also subject the country to very grave danger of excessive credit expansion. In the acquisition of its cash resources by the proposed bank no appreciable contraction of credit on the part of other banks would

take place. Payment for subscriptions to the capital of the Reserve Association—10 per cent of their own capital—will reduce somewhat the reserves of the other banks. If all the national banks subscribe, something like \$100,000,000 will be secured in this way, and assuming that the banks are then working close to reserve requirements some slight amount of contraction may prove necessary. The Government balance is to provide a portion of its funds but much the larger part will come from the deposits of other banks. At the outset these deposits will be built up almost entirely by the transfer to it of their cash reserves by the other banks. The deposited portion of the reserves of country and reserve-city banks are fairly certain to remain where they are in order to earn the interest paid for such balances. As the Reserve Association is very properly forbidden to pay interest on deposits, no appreciable change in these accounts is to be expected. It will thus be seen that practically all of the loans to be made by the Reserve Association will be a net addition to the available supply of credit. But the effect of these loans will be far greater than that of a similar amount of loans granted by an ordinary bank. Deposits with the Reserve Association will become the reserves of the other banks. At present including both cash and deposits with reserve agents the banks hold a reserve of about one fifth of their deposit liabilities. It follows that, in so far as loans by the Reserve Association increase the balances of the other banks with it, they will become a basis for loans by the other banks to something like five times their amount. This expansive effect applies only to that part of the loans made by the Reserve Association regularly to any particular bank or in any particular section of the country. It suggests the conclusion that the resources of the Reserve Association should be used principally, if not entirely, to enable the banks to meet temporary requirements and not to provide them with a modicum of constant accommodation.

It is, however, most doubtful whether the resources of the Bank proposed by Senator Aldrich would be adequate even for this purpose. Far from tending toward any considerable amount of credit expansion it may prove that its resources will be so limited that practically all of them will be held in reserve to meet emergencies. The Bank can hardly count upon a paid-up capital of more than \$125,000,000. The capital is to be provided by the other banks, each being permitted to subscribe to the amount

of 20 per cent of its capital, one half of which is to be paid in. On the basis of the existing capitalization of the national banks and assuming that all of them subscribe, almost exactly \$100,000,000 would be secured. Of course many state institutions may be converted into national banks but this change will doubtless take place very gradually; and, on the other hand, it is not at all certain that all the national banks will subscribe. A paid-in capital of \$125,000,000 would seem to be a liberal estimate for the first years of the Reserve Association. From the Government, taking the present Treasury balance as a basis, the Bank would receive about \$100,000,000. The only other possible source of funds is the deposits of other banks. Assuming that the deposited portion of the reserves of the banks remains with reserve agents, and assuming also that the banks transfer all their cash reserves except 5 per cent of their deposit liabilities retained as till money, and further deducting the \$100,000,000 paid in as capital there remain almost exactly \$400,000,000, which might be deposited in the Reserve Association by the national banks. Further funds would doubtless come from state institutions entering the national system. But at the outset it would hardly seem prudent to count upon securing as much as \$400,000,000 from the existing national banks. Many cautious bankers and others at a distance from any branch of the Reserve Association will be altogether likely to retain in their own vaults a cash reserve of more than 5 per cent against their deposits. Assuming further that the national banks take advantage of the provision in the bill regarding the relinquishment of their circulation in order to relieve themselves without loss of their holdings of Government bonds, the condition of the Reserve Association may be judged from the following statement:

<i>Liabilities</i>		<i>Assets</i>	
Capital	\$125,000,000	Government bonds.....	\$700,000,000
Bank notes.....	700,000,000	Banking premises, or- ganization expenses, and premiums on U. S. bonds.....	25,000,000
Government deposits..	100,000,000	Specie and legal tender notes	600,000,000
Bankers' deposits.....	400,000,000		
	<hr/>		<hr/>
	\$1,325,000,000		\$1,325,000,000

Ratio of reserve to demand liabilities, 50 per cent.

A reserve of 50 per cent is certainly no more than should normally be held by a bank with the heavy responsibilities which

will rest upon the proposed Reserve Association. Even if the estimate of the amount of bankers' deposits is too low the situation is bettered but slightly since any further increase in such deposits would only permit of an equivalent increase in loans so long as the 50 per cent ratio was maintained. Thus, if bankers' deposits should at the outset prove to be \$500,000,000 rather than \$400,000,000, making the cash reserve \$700,000,000, loans to the amount of \$100,000,000, whether in the form of notes or in deposits would bring down the reserve ratio to the 50 per cent level.

However strongly one may be convinced that the lending activities of the Reserve Association should ordinarily be of very moderate proportions it would seem clear that bankers' balances alone will not provide adequate resources. One further means of securing additional funds remains for consideration. Gold certificates to the amount of about \$900,000,000 are in circulation and as security for them an equivalent amount of gold is held in the Treasury. Doubtless a considerable part of the cash received by the Bank in subscriptions to its shares and in deposits by other banks will be in gold certificates, but much more than half of the existing issue will still remain in circulation. Many of these certificates would be received by the Bank in the ordinary course of payments to it. If we may assume that the practice is steadily followed of retaining the certificates or their gold equivalent, thus adding to the reserve, and if payments whenever acceptable are met in additional notes issued by the Bank, in no short time its reserve would be greatly enlarged. It would gradually strengthen the foundation for its lending operations. Suppose that \$300,000,000 of gold certificates were handled in this fashion. The reserve would then stand at \$900,000,000 while demand liabilities would have increased to \$1,500,000,000 giving a reserve ratio of 60 per cent. But the measure proposed by Senator Aldrich contains one serious obstacle to the adoption of this policy. All notes issued beyond the amount of the existing circulation of the national banks are to be heavily taxed. Upon the first \$100,000,000 there is to be a tax of 3 per cent which is to be increased by 1 per cent for each additional \$100,000,000 and all issues in excess of \$300,000,000 are to be taxed at the rate of 6 per cent. If the note issues of the Bank could be differentiated so that only those which were a net increase in the total amount of money in the country were subjected to a pro-

gressive tax no serious objection could be made to the arrangement. But this differentiation has not been attempted. A progressive tax upon the notes, increasing as the reserve ratio to demand liabilities declines, would seem to be a far more effective means of accomplishing the apparent purpose of the author of the measure. Such a provision would not prevent the Bank from taking advantage of the preference of the people for a paper circulating medium by substituting its own notes for gold certificates and thus increasing its specie reserve.

Perhaps the most troublesome obstacle which the bill will encounter on its passage is the opposition of state banks and trust companies. It is desirable that the services of the Reserve Association should be available for them, but on the other hand it is important that the banking system should be more unified than at present. Attractions are held out to state institutions to induce them to enter the national system and at the same time that system is made more serviceable through an extension of the range of operations open to the national banks. In addition to the services provided by the Reserve Association Senator Aldrich's plan contains provisions which will permit national banks to engage in trust company operations proper and also empowers them to establish separate savings departments, the funds of which may be invested in mortgage securities. In other words, virtually all kinds of business now carried on by state banks can in the future be carried on by national banks. Moreover the banks are authorized to accept a limited amount of commercial paper drawn upon them, a power which it is believed is not granted by any of the states.

These various inducements will probably attract many state banking institutions into the national system, but there remains an obstacle which will be regarded as very serious by a considerable number of banks including most of those whose business is of considerable magnitude. The reserve requirements of the national law are somewhat more onerous than those of the several states, though in the case of the country banks the difference is now much less than formerly. Entrance into the national system would not in general prove particularly burdensome except for state institutions carrying on business in reserve and central reserve cities. Much may be said for a change in the present reserve requirements merely as a means of securing a more exact relationship between the reserve ratio and the character of the

deposit liabilities and responsibilities of the existing national banks. No bank which holds large bankers' deposits should be permitted to keep its own reserve anywhere except in its own vaults or in a central bank whose primary function is to safeguard the entire credit structure. Reserve requirements should vary with the character of the business of the different banks and not be determined by their geographical situation. Banks should be permitted to qualify as reserve agents in any part of the country upon condition that they hold a reserve of 25 per cent either in their own vaults or with the Reserve Association. Banks confining themselves to a purely local business, wherever situated, should not be required to carry more than the reserve imposed on country banks.¹ If this modification were made in the present law state banks and trust companies, in Chicago for example, could qualify either as local banks or as reserve agents, and as their business is now chiefly of a local nature they would doubtless not enter into competition with banks occupying the wider field. Further, national banks in Chicago whose business is purely local would be relieved of an unnecessarily heavy burden.

With this change in reserve requirements, together with the other changes for which provision has already been made in the Aldrich plan, the opposition of state banking institutions to the proposal would be greatly diminished and there would be a reasonable prospect that all except those trust companies which carry on little or no banking business would enter the national system. In most of the states it would probably be necessary to secure legislative authority to enable national trust companies to act as trustees in certain matters, in particular in those under the jurisdiction of probate courts. To many of the companies, however, the trust department is of comparatively little importance and most of them would probably find it to their advantage to sacrifice some few of its functions if that should prove necessary in order to take advantage of the improved banking arrangements provided under the remodeled national law.

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¹ For a more detailed discussion of this proposal see my *Banking Reform in the United States*, pp. 88-100.